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A Bright Idea: A Bright-Line Test for Extraterritoriality in F-Cubed Securities Fraud Private Causes of Action

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A Bright Idea: A Bright-Line Test for Extraterritoriality in F-Cubed Securities Fraud Private Causes of Action

*Jennifer Mitchell Coupland**

Abstract: Whether a foreign or American claimant has a private right of action in so-called “Foreign-Cubed” or “Foreign-Squared” claims under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Securities and Exchange Commission (SEC) Rule 10b-5 has been the subject of much debate among U.S. courts, Congress, and the international community. Historically, these cases have been heard in the United States if the conduct had a substantial effect in the United States or on U.S. citizens (the effects test), or if the fraudulent or wrongful conduct occurred in the United States (the conduct test). However, in June 2010, the United States Supreme Court struck down both of these tests in favor of a transactional test.

While the Supreme Court seemingly resolved many questions surrounding extraterritorial issues inherent in securities class action suits with its adoption of this transactional test, Congress may have re-opened the issue with the passage of the Dodd-Frank Act. This article argues that Congress and the SEC should limit the extraterritoriality of the Exchange Act on private securities fraud litigation. Additionally, this article argues that both Congress and the SEC should provide courts with a bright-line rule regarding the extraterritorial reach of the Exchange Act.

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I. INTRODUCTION

Whether a foreign or American claimant has a private right of action in so-called “Foreign-Cubed”¹ or “Foreign-Squared”² claims under Section 10(b) of the Securities Exchange Act of 1934³ (Exchange Act) and Securities and Exchange Commission (SEC) Rule 10b-5⁴ has been the subject of much debate among U.S. courts, Congress, and the international community. Historically, these cases have been heard in the United States if the conduct had a substantial effect in the United States or on U.S. citizens (the effects test), or if the fraudulent or wrongful conduct occurred in the United States (the conduct test).⁵ However, in June 2010, the United States Supreme Court struck down both of these tests in favor of a transactional test, which looks to one of two factors: (1) “whether the purchase or sale [of the security] is made in the United States,” or (2) whether the security is listed on a U.S. exchange.⁶

While the Supreme Court seemingly resolved many questions surrounding extraterritorial issues inherent in securities class action suits with its adoption of this transactional test, Congress may have re-opened

¹ Foreign-Cubed is a term used to define transactions in which foreign shareholders purchase stock of a foreign issuer on a foreign exchange. Seth Aronson et al., *Developments and Trends in Securities Litigation: 2009–10*, in SECURITIES LITIGATION & ENFORCEMENT 2010, at 363, 387 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1832, 2010).

² Foreign-Squared is a term used to define transactions in which U.S. shareholders purchase stock of a foreign issuer on a foreign exchange. See Louis M. Solomon, *Court Dismisses Both “Foreign Cubed” as Well as “Foreign Squared” Securities Claims Based on Morrison*, CADWALADER INT’L PRAC. L. BLOG (Sept. 19, 2011), <http://blog.internationalpractice.org/international-practice/court-dismisses-both-foreign-cubed-as-well-as-foreign-squared-securities-claims-based-on-morrison.html>.

³ Securities Exchange Act of 1934, ch. 404, Pub. L. 73–291, 48 Stat. 881 (codified at 15 U.S.C. § 78 et seq.).

⁴ 17 C.F.R. § 240.10b-5 (2011).

⁵ See Hannah L. Buxbaum, *Multinational Class Actions Under Federal Law: Managing Jurisdictional Conflict*, 46 COLUM. J. TRANSNAT’L L. 14, 21–23 (2007).

⁶ *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2886 (2010).

the issue with the passage of the Dodd-Frank Act. In July 2010, Congress passed Section 929Y of the Dodd-Frank Act, which requires the SEC to determine whether the provision for a private right of action for securities fraud under the Exchange Act should extend to claims involving foreign issuers.⁷ In addition, Section 929P of the Dodd-Frank Act creates extraterritoriality in SEC and Department of Justice enforcement actions.⁸

This article argues that Congress and the SEC should limit the extraterritoriality of the Exchange Act on private securities fraud litigation. Additionally, this article argues that both Congress and the SEC should provide courts with a bright-line rule regarding the extraterritorial reach of the Exchange Act. Part II examines the current regulatory and judicial landscape of securities fraud private litigation. Included in this is a discussion of *Morrison v. National Australia Bank*, the recent Supreme Court decision that struck down both the conduct and effects tests. Part III discusses what, if any, effect the Dodd-Frank Act will have on the Supreme Court's decision in *Morrison*. Part IV examines the factors that the SEC should consider when determining whether to apply extraterritoriality in civil actions for securities fraud. These factors include the legislative history of securities fraud litigation, the policy reasons both for and against a finding of extraterritoriality, the international consequences of such a finding, and the economic consequences of extraterritoriality. This section concludes that, based on an analysis of these factors, the SEC should limit the application of Section 10(b) and Rule 10b-5 to cases that meet the transactional test defined above. Finally, Part V concludes that the SEC should not recommend that Rule 10b-5 be modified to allow for extraterritoriality, but that the SEC should instead establish a bright-line rule such as the one adopted by the Court in *Morrison*.

II. THE CURRENT LANDSCAPE OF SECURITIES FRAUD LITIGATION

Foreign-Cubed, or “F-Cubed,” is a term used to define transactions in which foreign shareholders purchase stock of a foreign issuer on a foreign exchange.⁹ Foreign-Squared, or “F-Squared,” litigation, similar to F-Cubed, involves transactions on a foreign exchange involving a foreign issuer.¹⁰ However, unlike F-Cubed transactions, the purchaser is a U.S. citizen.¹¹

In 2011 a total of sixty-one federal securities class actions were filed

⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929Y, 124 Stat. 1376, 1871 (2010).

⁸ *Id.* § 929P(b), 124 Stat. at 1841–49.

⁹ Aronson et al., *supra* note 1, at 387.

¹⁰ Solomon, *supra* note 2.

¹¹ *Id.*

against foreign issuers—a more than 50% increase from the twenty-seven filed in 2010.¹² Surprisingly, the number of cases increased significantly after the *Morrison* decision, with sixteen of the twenty-seven cases in 2010 filed after the June 2010 decision.¹³ A study released by PricewaterhouseCoopers (PwC) points to a number of factors that could help explain this surprising increase.¹⁴ First, PwC stated that the increase was largely attributable to Chinese companies.¹⁵ In 2011, thirty-seven of the sixty-one and in 2010, twelve of the twenty-seven cases filed against foreign investors were filed against Chinese companies.¹⁶ The complaints in a number of these cases included claims that the “revenue and profit figures reported in SEC filings were considerably different from those reported to Chinese authorities.”¹⁷ Second, PwC observed that the increase could be due to a few high-profile events that resulted in litigation against foreign issuers, such as BP and Transocean.¹⁸

A. The Securities Exchange Act of 1934

The Exchange Act created the SEC and granted it the authority to enforce U.S. securities regulations.¹⁹ Included in this authority is “the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self regulatory organizations (SROs).”²⁰ The Exchange Act requires companies with

¹² PATRICIA A. ETZOLD & NEIL KEENAN, PRICEWATERHOUSECOOPERS LLP, THE EVER-CHANGING LANDSCAPE OF LITIGATION COMES FULL CIRCLE: 2011 SECURITIES LITIGATION STUDY 3, 5 (2012), available at http://10b5.pwc.com/PDF/2011_SECURITIES_LITIGATION_STUDY_14_INTERACTIVE.PDF. GRACE LAMONT & NEIL KEENAN, PRICEWATERHOUSECOOPERS LLP, LOOKING BEYOND A DECADE OF FRAUD, CORRUPTION, AND TURMOIL: 2010 SECURITIES LITIGATION STUDY 42 (2011), available at http://10b5.pwc.com/PDF/NY-11-0484%20SEC%20LIT%20STUDY_V6BONLINE.PDF. A total of thirty-six cases were brought against foreign issuers in 2008. GRACE LAMONT & PATRICIA A. ETZOLD, PRICEWATERHOUSECOOPERS, 2009 SECURITIES LITIGATION STUDY 35 (2010), available at http://10b5.pwc.com/PDF/NY-10-0559%20SEC%20LIT%20STUDY_V7%20PRINT.PDF.

¹³ LAMONT & KEENAN, *supra* note 12, at 42.

¹⁴ *Id.* at 42–51.

¹⁵ *Id.* at 43.

¹⁶ ETZOLD & KEENAN, *supra* note 12, at 3; LAMONT & KEENAN, *supra* note 12, at 42.

¹⁷ *Id.*

¹⁸ *Id.* at 44. Both BP and Transocean were the subject of several class actions whose complaints charged both companies with violations of the Exchange Act for the dissemination of false and misleading statements about deficient safety protocols and their operating and safety record. *Id.*

¹⁹ Securities Exchange Act of 1934, ch. 404, § 4, 48 Stat. at 885 (codified at 15 U.S.C. § 78d (2006)); *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml#secexact1934> (last modified Feb. 15, 2012).

²⁰ *The Laws that Govern the Securities Industry*, *supra* note 19 (defining self-regulatory organizations as including the New York Stock Exchange and the American Stock

publicly traded securities to follow certain corporate reporting and disclosure requirements.²¹ It also prohibits certain behavior, such as securities fraud, and grants specific disciplinary authority over companies and individuals that fall within its regulatory powers.²²

Section 10(b) of the Exchange Act and Rule 10b-5 prohibit securities fraud.²³ And, while they do not explicitly prohibit or allow plaintiffs to bring a private cause of action in U.S. courts involving foreign securities, foreign transactions, foreign issuers, and foreign purchasers, courts have historically heard such cases.²⁴ The Securities Act of 1933 states in its provision on jurisdiction that:

The district courts of the United States . . . shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto . . . of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.²⁵

In addition, the language in Rule 10b-5, which provides even less clarity, states that it is unlawful for any person to use any “means or instrumentality of interstate commerce . . . or of any facility of any national securities exchange” to carry out a deceptive act.²⁶ Because the language in the Exchange Act is ambiguous as to whether F-Cubed or F-Squared claims have standing in the United States, this determination has largely been left

Exchange).

²¹ *Id.*

²² *Id.*

²³ Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. at 891 (codified at 15 U.S.C. § 78j); 17 C.F.R. § 240.10b-5 (2011).

²⁴ *See, e.g.,* Itoba Ltd. v. Lep Grp. PLC, 54 F.3d 118 (2d Cir. 1995); IIT v. Vencap Ltd., 519 F.2d 1001 (2d Cir. 1975); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968).

²⁵ Securities Act of 1933, ch. 38, § 22, 48 Stat. 74, 86 (codified at 15 U.S.C. § 77v(a) (2006)); *see also* Securities Exchange Act of 1934 § 27, 48 Stat. at 902–03 (codified at 15 U.S.C. § 78aa) (setting forth the jurisdictional rules of the Exchange Act).

²⁶ 17 C.F.R. § 240.10b-5 (2011). Section 10(b) provides that

it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ . . . any manipulative or deceptive device or contrivance.

Securities Exchange Act of 1934 § 10(b), 48 Stat. at 891 (codified at 15 U.S.C. § 78j).

to the courts. This has resulted in unpredictable, inconsistent, and often over-reaching decisions.

Courts have traditionally applied one of two tests to justify making such a determination: the conduct test or the effects test.²⁷ The conduct test looks to “whether the wrongful conduct occurred in the United States.”²⁸ The effects test looks to “whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.”²⁹ However, courts often apply these two tests inconsistently.³⁰

1. The Conduct Test

The conduct test looks to where the fraudulent conduct takes place.³¹ The level of conduct sufficient to establish U.S. jurisdiction is the subject of much debate, though, and U.S. circuit courts are divided over the level of conduct necessary to satisfy the test.³² The Second Circuit first articulated the conduct test in *Leasco Data Processing Equipment Corp. v. Maxwell*,³³ and then again applied the test in *Itoba Ltd. v. Lep Group PLC*, in which the court held that the conduct test is satisfied when “(1) the defendant’s activities in the United States were more than ‘merely preparatory’ to a securities fraud conducted elsewhere,”³⁴ and (2) the “activities or culpable failures to act within the United States ‘directly caused’ the claimed losses.”³⁵

While the Fifth and Seventh Circuits generally follow the Second Circuit’s test,³⁶ the Third, Eighth, and Ninth Circuits have applied a looser

²⁷ See, e.g., *Itoba Ltd.*, 54 F.3d 118 (applying both the conduct and effects tests); *Vencap Ltd.*, 519 F.2d 1001 (applying the effects test); *Leasco Data Processing Equip. Corp.*, 468 F.2d 1326 (applying the conduct test); *Schoenbaum*, 405 F.2d 200 (applying the effects test).

²⁸ *SEC v. Burger*, 322 F.3d 187, 192 (2d Cir. 2003).

²⁹ *Id.*

³⁰ See Bertrand C. Sellier & Stacy Ceslowitz, *Extraterritorial Application of U.S. Laws; Employment and Securities Laws*, *Proskauer on International Litigation and Arbitration*, PROSKAUER, http://www.proskauerguide.com/law_topics/25/IV (last visited Apr. 18, 2012) (“Application of the conduct and effects test has not been consistent . . .”).

³¹ See *Burger*, 322 F.3d at 192.

³² J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT’L L. & BUS. 207, 217 (1996).

³³ 468 F.2d 1326 (2d Cir. 1972) (stating that the court had jurisdiction over the plaintiffs’ fraud claims even though the plaintiffs, who were U.S. citizens, purchased stock in a foreign corporation, the corporation’s stock was not traded on a U.S. exchange, and the trade was executed by foreign brokers).

³⁴ *Itoba Ltd. v. Lep Grp. PLC*, 54 F.3d 118, 122 (2d Cir. 1995).

³⁵ *Id.*; see also *Burger*, 322 F.3d at 187; *IIT v. Vencap Ltd.*, 519 F.2d 1001 (2d Cir. 1975); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975); *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972).

³⁶ See, e.g., *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 666 (7th Cir. 1998); *Robinson v. TCI/US West Cable Communications, Inc.*, 117 F.3d 900, 906 (5th Cir. 1997).

standard.³⁷ The Second Circuit's test requires a finding that the foreign defendant's conduct in the United States directly caused the plaintiff's claimed losses.³⁸ However, the Third, Eighth, and Ninth Circuits' test only requires that the foreign defendant's conduct in the United States played a *significant* role in the allegedly fraudulent conduct that caused the plaintiff's claimed losses.³⁹ In *Continental Grain v. Pacific Oilseeds*, the Eighth Circuit held that the court would find jurisdiction where the domestic conduct "was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment."⁴⁰ Conversely, the D.C. Circuit has adopted perhaps the most stringent application of the conduct test,⁴¹ requiring "that all factors required to establish a securities fraud claim under . . . Section 10(b) [of the Exchange Act] must have occurred in the U.S."⁴²

2. *The Effects Test*

In addition to the conduct test, the Second Circuit has also set forth a test that looks to whether the allegedly fraudulent conduct had a substantial effect in the United States or on U.S. citizens.⁴³ Referred to as the effects test, it is often applied in conjunction with the conduct test because, historically, the effects test has been insufficient on its own.⁴⁴

The effects test was first articulated in *Schoenbaum v. Firstbrook*, where a court found jurisdiction based on the effect the transaction had on American citizens and on American financial markets.⁴⁵ In *Schoenbaum*, an American shareholder of Banff Oil Ltd., a Canadian corporation, brought

³⁷ See, e.g., *Butte Mining PLC v. Smith*, 76 F.3d 287, 291 (9th Cir. 1996) ("Vigilant and mature as our securities laws are, they are not to be invoked unless substantial steps in the perpetuation of the fraud were taken here or the criminal conduct engaged in affected our securities markets or American investors."); *Cont'l Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 420–21 (8th Cir. 1979); *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir. 1977).

³⁸ *Itoba*, 54 F.3d at 122.

³⁹ See, e.g., *Butte Mining PLC*, 76 F.3d at 291; *Cont'l Grain*, 592 F.2d at 420–21; *Kasser*, 548 F.2d at 114.

⁴⁰ *Cont'l Grain*, 592 F.2d at 421 (finding that letters and telephone calls that took place in the United States were sufficient to establish conduct "in furtherance of a fraudulent scheme").

⁴¹ *Sellier & Ceslowitz*, *supra* note 30.

⁴² *Id.*; see also *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27 (D.C. Cir. 1987) (holding that the conduct itself must violate section 10(b) of the Exchange Act and Rule 10b-5).

⁴³ *SEC v. Burger*, 322 F.3d 187, 192 (2d Cir. 2003).

⁴⁴ *Itoba Ltd. v. Lep Grp. PLC*, 54 F.3d 118, 122 (2d Cir. 1995) ("There is no requirement that these two tests be applied separately and distinctly from each other. Indeed, an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court. It is in this manner that we address the issue of jurisdiction in the instant case.").

⁴⁵ 405 F.2d 200, 204–05 (2d Cir. 1968); see also *Choi & Guzman*, *supra* note 32, at 217.

a shareholder derivative suit to recover losses under Section 10(b) of the Exchange Act against Aquitaine of Canada, Ltd., a wholly owned subsidiary of a French corporation, and Paribas Corporation, a Delaware corporation doing business in New York.⁴⁶ Banff's stock was registered with the SEC and traded on both the American Stock Exchange and the Toronto Stock Exchange.⁴⁷ The allegedly fraudulent conduct took place outside of the United States.⁴⁸ Although the district court dismissed the case on the grounds that it lacked jurisdiction, the Second Circuit reversed the district court's decision and held that even though the conduct occurred entirely within Canada, the court had subject matter jurisdiction over cases involving transactions that "are detrimental to the interests of American investors."⁴⁹

Both the conduct and effects tests have governed extraterritoriality questions in private securities fraud litigation since the 1970s. The Supreme Court, however, in one fell swoop, nullified both tests when it denied extraterritoriality in *Morrison v. National Australia Bank*.⁵⁰

B. *Morrison*: The Supreme Court Adopts a New Test

On June 24, 2010, the United States Supreme Court, in *Morrison v. National Australia Bank*, held that Section 10(b) of the Exchange Act applies only to transactions involving domestic securities and to domestic transactions of foreign securities.⁵¹ In a unanimous ruling, the Court struck down both the conduct and effects tests, stating that the statute provides no textual support for such tests.⁵² The Court stated that "it is [the Court's] function to give the statute the effect its language suggests, however modest that may be; not to extend it to admirable purposes it might be used to achieve."⁵³

The petitioners in *Morrison* were Australian citizens who purchased shares of National Australia Bank (National) on the Australian Stock Exchange.⁵⁴ National, the largest bank in Australia at the time of filing, purchased HomeSide Lending, Inc. (HomeSide), a U.S.-based mortgage servicing company headquartered in Florida.⁵⁵ National's shares are traded on the Australian Stock Exchange and on other foreign securities

⁴⁶ *Schoenbaum*, 405 F.2d at 204.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ Choi & Guzman, *supra* note 32, at 218.

⁵⁰ *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010).

⁵¹ *Id.* at 2884.

⁵² *Id.* at 2833.

⁵³ *Id.* at 2886.

⁵⁴ *Id.* at 2873.

⁵⁵ *Id.* at 2875.

exchanges, but not on any exchanges in the United States.⁵⁶ However, National's shares of American Depositary Receipts (ADRs) are traded on the New York Stock Exchange (NYSE).⁵⁷ In July 2001, National announced that it was "writing down the value of HomeSide's assets by \$450 million."⁵⁸ Later, in September 2001, National announced that it was writing down HomeSide's assets by \$1.75 billion, a significant increase from National's quote in July 2001.⁵⁹

Based on the announcements in July and September, the petitioners alleged that HomeSide and a number of its senior executives manipulated its financial models "to make the rates of early repayment unrealistically low in order to cause the mortgage servicing rights to appear more valuable than they really were."⁶⁰ The petitioners claimed that National was aware of this deception when it announced that it wrote down the value of HomeSide's assets.⁶¹ The Second Circuit rejected the case for lack of subject matter jurisdiction under Federal Rule of Civil Procedure 12(b)(1),⁶² concluding that the conduct that occurred in Florida was merely a link in a chain of conduct that ultimately took place in Australia.⁶³

While the Supreme Court upheld the Second Circuit's dismissal of the case, it rejected the lower court's reasoning. The Court stated that the case should not have been dismissed for lack of subject matter jurisdiction, but instead held that "what conduct § 10(b) prohibits . . . is a merits question" analyzed more properly under Federal Rule of Civil Procedure Rule 12(b)(6).⁶⁴ Thus, "the proper question was whether the plaintiffs' allegations warranted relief."⁶⁵

The Court also stated that where a statute is silent on extraterritoriality, or where Congress has not directly expressed its intent for the statute to

⁵⁶ *Morrison*, 130 S.Ct. at 2872.

⁵⁷ *Id.* at 2875 (ADRs "represent the right to receive a specified number of National's Ordinary Shares."). More generally, ADRs are traded on a U.S. exchange and "represent[] ownership of equity shares in a foreign company." *Find Out About DRs*, J.P.MORGAN, <https://www.adr.com/Education/AboutDRs> (last visited Apr. 19, 2012) (click DR Definitions link).

⁵⁸ *Morrison*, 130 S. Ct at 2875–76.

⁵⁹ *Id.* at 2876.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* at 171–72 (finding lack of subject matter jurisdiction because the "conduct amounted to, at most, a link in the chain of a scheme that culminated abroad").

⁶³ *Id.* at 176 ("The actions taken and the actions not taken by NAB in Australia were, in our view, significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida.").

⁶⁴ *Morrison*, 130 S. Ct. at 2877 ("Subject-matter jurisdiction, by contrast, 'refers to a tribunal's power to hear a case.'").

⁶⁵ Vincent M. Chiappini, Note, *How American Are American Depositary Receipts? ADRs, Rule 10b-5 Suits, and Morrison v. National Australia Bank*, 52 B.C. L. REV. 1795, 1802 (2011).

apply extraterritorially, there is a presumption against extraterritoriality.⁶⁶ Because neither Section 10(b) nor Rule 10b-5 addresses the extraterritorial application of the rule, and Congress has not expressly stated its intent for the statute to apply extraterritorially, the Court reasoned that there was a presumption against such a finding.⁶⁷

Going one step further, the Court provided a framework under which such suits should be decided. First, the Court rejected the conduct and effects tests traditionally used in Foreign-Cubed cases.⁶⁸ Second, the Court adopted a transactional test.⁶⁹ The Court stated that whether there is a private cause of action under Section 10(b) depends on whether the purchase or sale of the security is made in the United States or whether the security in the transaction is listed on a United States stock exchange.⁷⁰ In *Morrison*, the plaintiffs did not meet the transactional test because their shares were not purchased on a U.S. exchange.

C. Impact of *Morrison*

Within six months of the Supreme Court's ruling in *Morrison*, almost 200 courts had cited *Morrison*.⁷¹ In one of the earliest cases to apply the transactional test outlined in *Morrison*, the District Court for the Southern District of New York, in *Cornwell v. Credit Suisse Group*, which involved an F-Squared claim, held that *Morrison* applied to Foreign-Squared cases as well as Foreign-Cubed cases.⁷² The court stated that the Exchange Act "would not apply to transactions involving (1) a purchase or sale, wherever it occurs, of securities listed only on a foreign exchange, or (2) a purchase or sale of securities, foreign or domestic, which occurs outside the United States."⁷³

The plaintiffs in *Cornwell* consisted of two categories of investors:

⁶⁶ *Id.*; see also *Equal Emp't Opportunity Comm'n v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 ("Legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.").

⁶⁷ *Morrison*, 130 S. Ct. at 2883 ("In short, there is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and we therefore conclude that it does not.").

⁶⁸ *Id.* at 2884.

⁶⁹ *Id.* at 2884, 2886 (stating that the effects test and the conduct test are not the proper standards in Foreign-Cubed cases).

⁷⁰ *Id.* at 2884.

⁷¹ Edward Pekarek & Anna Dokuchayeva, *French Disconnection II – Fab's Failed F-Cubed Theory; Judge Jones Closes Morrison Doors on Goldman Exec*, SEC. LITIG. & ARB. (December 14, 2010, 8:25 PM), http://nysbar.com/blogs/SecuritiesLitigation/2010/12/french_disconnection_ii_fabs_f.html; see, e.g., *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166 (S.D.N.Y. 2010); *Cornwell v. Credit Suisse Grp.*, 729 F. Supp. 2d 620 (S.D.N.Y. 2010).

⁷² *Cornwell*, 729 F. Supp. 2d 620.

⁷³ *Id.* at 623–24.

“(1) [investors] who purchased ADRs on the NYSE and (2) [investors] who are U.S. residents who purchased Credit Suisse shares on the Swiss Stock Exchange.”⁷⁴ The plaintiffs contended that the U.S. securities laws applied because their investment decision was made in the United States, they “initiated a purchase of CSG[’s stock] from the U.S.,” accepted the CSG stock into their account in the United States, and “incurred an economic risk in the U.S.”⁷⁵ The plaintiffs also claimed that because the facts were not synonymous with those in *Morrison*—the plaintiffs in *Cornwell* were U.S. residents, unlike those in *Morrison*—the reasoning in *Morrison* should not apply in the present case.⁷⁶ The court rejected this distinction, stating that even if the applicable reasoning in *Morrison* was dictum, “‘it does not at all follow that [this Court] can cavalierly disregard it,’ especially where the Supreme Court ‘is providing a construction of a statute to guide the future conduct of inferior courts.’”⁷⁷ The district court emphasized that in looking at the totality of the *Morrison* opinions, it was obvious that the *Morrison* Court had not intended the anti-fraud provisions to extend to securities traded on foreign exchanges, even if the securities were purchased or sold by American investors.⁷⁸

In *Plumber’s Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, the plaintiffs alleged that Swiss Reinsurance Co. (Swiss Re) violated Section 10(b) of the Exchange Act and Rule 10b-5 “by making false or materially misleading disclosures about Swiss Re’s risk management and exposure to mortgage-related securities.”⁷⁹ Swiss Re is a Swiss corporation whose stock is listed on the SWX Swiss Exchange.⁸⁰ While the purchase order for the plaintiff’s shares was placed in Chicago, the court emphasized that the share transactions “were executed, cleared, and settled on the virt-x trading platform, which was a subsidiary of the SWX Swiss Exchange based in London.”⁸¹ Applying the holding in *Morrison*, the District Court for the Southern District of New York held that “a purchase order in the United States for a security that is sold on a foreign exchange is insufficient to subject the purchase to the coverage of section 10(b) of the Exchange

⁷⁴ Samuel Wolff, *The Extraterritorial Application of Section 10(b)*: *Morrison v. National Australia Bank—Part 2*, SEC. & FED. CORP. L. REP., Apr. 2011. The court dismissed the plaintiffs who had purchased their shares on the Swiss Stock exchange, but did not dismiss the plaintiffs who had purchased ADRs on the NYSE. *Id.*

⁷⁵ *Cornwell*, 729 F. Supp. 2d at 622.

⁷⁶ *See id.* at 626 (pointing to the fact that the plaintiffs in *Morrison* were foreign citizens, unlike the plaintiffs in *Cornwell*, who were American citizens).

⁷⁷ *Id.* at 625 (citing *United States v. Bell*, 524 F.2d 202, 206 (2d Cir. 1975)).

⁷⁸ *Id.* at 625–26.

⁷⁹ *Plumber’s Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 170 (S.D.N.Y. 2010).

⁸⁰ *Id.* at 171–72.

⁸¹ *Id.* at 166, 172.

Act.”⁸² The court rejected the plaintiffs’ argument that the purchase occurred in the United States because the order for the stock had been placed in the United States.⁸³

The district court in *In re Alstom SA Securities Litigation* further interpreted the ruling in *Morrison*, holding that it is not sufficient that the securities are listed on a domestic exchange.⁸⁴ Rather, the transaction itself must occur on a domestic exchange.⁸⁵ The plaintiffs in *Alstom* made two arguments for application of Section 10(b): (1) the purchase of shares on Euronext was initiated in the United States; and (2) the issuer had ADRs listed on the NYSE, despite the fact that the purchase occurred on Euronext.⁸⁶ The court dismissed both of the plaintiffs’ arguments, stating that the “the transactions themselves must occur on a domestic exchange to trigger application of § 10(b).”⁸⁷

Critics of the decision in *Morrison* argue that the court failed to clearly address whether Section 10(b) applies in cases where the securities in question are ADRs. ADRs are “vehicles for Americans to invest in foreign corporations through an intermediary bank, which holds the actual foreign security, and through which the investor receives an ADR representing his ownership interest.”⁸⁸ Not all ADRs are listed on an exchange, but in *Morrison*, the Court clearly stated that National’s ADRs were traded on the NYSE.⁸⁹ The Court, however, seemed to overlook the issue of whether ADRs listed on the NYSE are in fact listed on a domestic exchange.⁹⁰ “This renders inaccurate the Court’s statement that the securities at issue in

⁸² *Id.* at 177–78.

⁸³ Wolff, *supra* note 74 (“The Court rejected the arguments that the transaction was a domestic one because the plaintiff is a US resident, made the decision in the United States, suffered harm in the United States, and placed orders for the securities from the United States. The Court held that citizenship and residency do not affect where a transaction occurs.”).

⁸⁴ *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469 (S.D.N.Y. 2010).

⁸⁵ *Id.* at 473.

⁸⁶ Wolff, *supra* note 74.

⁸⁷ *In re Alstom SA Sec. Lit.*, 741 F. Supp. 2d at 473.

⁸⁸ Chiappini, *supra* note 65, at 1796.

⁸⁹ *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2875 (2010); *see also* Genevieve Beyea, *Morrison v. National Australia Bank and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 537, 565 (2011).

⁹⁰ *See* Beyea, *supra* note 89, at 564–65.

If a company lists ADRs on a national stock exchange, the ADRs (representing American Depositary Shares, or ADSs) must be registered with the Securities and Exchange Commission pursuant to Section 12(b) of the Exchange Act, and the registration process typically involves the registration of two securities: the underlying shares and the ADSs themselves. In addition, ordinary shares underlying the listed ADRs are technically also listed on the exchange.

Id.

Morrison were not registered on a domestic exchange, since technically the [National] common stock underlying the ADRs was listed on the NYSE.”⁹¹

Since *Morrison*, a number of courts have been faced with the issue of whether Section 10(b) applies to cases where the securities are ADRs listed on a domestic exchange. One such decision is *Cornwell v. Credit Suisse*, where the court did not dismiss a case in which the plaintiffs had purchased ADRs on the NYSE.⁹² Conversely, in *In re Societe Generale Securities Litigation*, the court ruled that ADRs purchased on over-the-counter markets in the United States were not covered by Section 10(b).⁹³ These two cases illustrate the confusion among district courts regarding not only what ADRs are, but also how they work and how they are regulated.

The case law post-*Morrison* not only illustrates how lower courts have applied the Supreme Court’s holding, but also reveals some of the weaknesses in the decision, as well as the uncertainties created by the decision. The future of *Morrison*, however, is uncertain. While many in the international community have embraced the decision in *Morrison*, others, including members of Congress, have met it with significant skepticism.⁹⁴ Moreover, the recently-passed Dodd-Frank Act may severely reduce the reach of *Morrison*.

III. THE DODD-FRANK ACT

On July 15, 2010, Congress approved House Resolution 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act), and President Obama signed the Dodd-Frank Act into law on July 21, 2010.⁹⁵ The Act is considered by many to be the most controversial and “ambitious overhaul of financial regulation” since the Great Depression.⁹⁶ The Dodd-Frank Act’s stated purpose is “[t]o promote

⁹¹ *Id.* at 565–66.

⁹² *Cornwell v. Credit Suisse*, 729 F. Supp. 2d 620 (S.D.N.Y. 2010).

⁹³ *In re Societe Generale Sec. Lit.*, No. 08 Civ. 2495(RMB), 2010 WL 3910286 (S.D.N.Y. 2010).

⁹⁴ See Luke Green, *Foreign Pension Funds Call for Reversal of Morrison*, INSIGHT: SECURITIES LITIGATION (Mar. 17, 2011, 1:02 PM), <http://blog.riskmetrics.com/slw/2011/03/foreign-pension-funds-call-for-reversal-of-morrison.html> (stating that, post-*Morrison*, many of the pension funds’ purchase of international equity investments would fall out of the purview of U.S. courts).

⁹⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *H.R. 4173 (111th): Dodd-Frank Wall Street Reform and Consumer Protection Act*, GOVTRACK, <http://www.govtrack.us/congress/bill.xpd?bill=h111-4173> (last visited Apr. 19, 2012).

⁹⁶ See Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST (July 16, 2010), <http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464.html>; see also Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J. (July 16, 2010), <http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html>; *Obama Signs Sweeping Financial Overhaul, Pledges ‘No More’ Bailouts*, FOX NEWS (July 21, 2010), <http://www.foxnews.com/>

the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”⁹⁷

Over 2,000 pages long, the Dodd-Frank Act affects almost all financial regulatory agencies, including the SEC, contains over 200 rulemaking provisions, and commissioned nearly 60 studies.⁹⁸ Two provisions in the Act, Section 929P and Section 929Y, address the extraterritorial reach of federal securities laws.⁹⁹ The first, Section 929P, establishes the extraterritorial reach of the SEC and the Department of Justice in enforcement actions.¹⁰⁰ This section modifies Section 22 of the Securities Act of 1933 (Securities Act) and Section 27 of the Exchange Act, both of which give federal district courts and state courts jurisdiction over violations and offenses that arise under either one of the acts, but which did not expressly address the extraterritorial application of the acts.¹⁰¹ Modifying the two acts, Section 929P states that both federal and state courts have jurisdiction over enforcement proceedings involving: “(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect

politics/2010/07/21/obama-poised-sign-sweeping-financial-overhaul/.

⁹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, pmbll., 124 Stat. at 1376.

⁹⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Shah Gilani, *By Yanking the Teeth Out of Dodd-Frank Act Ratings Rules, SEC Blunts Hope for Real Financial Reforms*, MONEY MORNING (DEC. 1, 2010), <http://moneymorning.com/2010/12/01/dodd-frank-act-ratings-rules-sec-financial-reforms/>.

⁹⁹ LAMONT & KEENAN, *supra* note 12, at 38; *see, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 929P, 929Y 124 Stat. at 1862–65, 1871.

¹⁰⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(b), 124 Stat. at 1864–65.

¹⁰¹ *See id.* Section 22 of the Securities Act states that “[t]he district courts of the United States and United States courts of any Territory shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission.” Securities Act of 1933, ch. 38, § 22, 48 Stat. 74, 86 (codified at 15 U.S.C. § 77v (2006)). Section 27 of the Exchange Act states that:

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder.

Securities Exchange Act of 1934, ch. 404, § 22, 48 Stat. 881, 902 (codified at 15 U.S.C. § 78aa (2006)).

within the United States.”¹⁰²

The second provision, Section 929Y, requires the SEC to undertake a study to determine whether private rights of action under Section 10(b) of the Exchange Act and Rule 10b-5 should be extended to cover “(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.”¹⁰³ In conducting the study, the Act states that the SEC should consider, among other things, the scope of the private right of action, the effect on international comity if the private right of action is modified to provide for extraterritorial jurisdiction, the economic costs and benefits of such a modification, and the scope of the extraterritorial jurisdiction.¹⁰⁴

IV. FACTORS THE SEC SHOULD CONSIDER

The SEC should consider a number of factors when analyzing the question of extraterritorial application of Section 10(b) of the Exchange Act and Rule 10b-5. These factors include (1) the legislative history of private litigation in Foreign-Cubed and Foreign-Squared cases, (2) the policy reasons in support of extending jurisdictional reach, (3) the international consequences of extraterritoriality, (4) the economic consequences of extending extraterritoriality, and (5) the administrative consequences of extending extraterritoriality. A consideration of these factors indicates that, while the historical and policy justifications may be compelling reasons for extending the jurisdictional reach of Section 10(b) and Rule 10b-5, they do not outweigh the international and economic consequences of such a finding.

A. Legislative History

When Congress passed the Dodd-Frank Act, it clearly extended the SEC’s and the Department of Justice’s jurisdictional reach in enforcement actions to include securities transactions that occurred abroad if either the conduct occurred in the United States or if the conduct occurred outside of the United States but had a substantial effect on the United States.¹⁰⁵ However, the Dodd Frank Act does not explicitly extend jurisdiction to American courts over private causes of action.¹⁰⁶ Thus, the question is

¹⁰² Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(b), 124 Stat. at 1864.

¹⁰³ Dodd-Frank Wall Street Reform and Consumer Protection Act § 929Y, 124 Stat. at 1864.

¹⁰⁴ *Id.*

¹⁰⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(b), 124 Stat. at 1864.

¹⁰⁶ *See supra* Part III for discussion of the Dodd-Frank Act.

whether the SEC should look to the legislative record regarding the enforcement powers of the SEC and the Department of Justice as proof that Congress intended to extend extraterritorial jurisdiction in private causes of action.

In a proceeding before the House of Representatives on June 30, 2010, Representative Kanjorski, one of the drafters of Section 929P of the Act, stated that the intention of the bill was to codify investors' ability to bring causes of action under both the conduct test and the effects test.¹⁰⁷ He stated:

In the case of *Morrison v. National Australia Bank*, the Supreme Court last week held that section 10(b) of the Exchange Act applies only to transactions in securities listed on United States exchanges and transactions in other securities that occur in the United States. In this case, the Court also said that it was applying a presumption against extraterritoriality. This bill's provisions concerning extraterritoriality, however, are intended to rebut that presumption by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department.¹⁰⁸

Here, the legislative record is relevant in so much as it shows the drafters of Dodd-Frank intended extraterritorial application to apply in SEC and Justice Department enforcement cases only. Even though Section 929Y commissions the SEC to conduct a study regarding extraterritorial application in private civil cases, the legislative intent behind Section 929P should not be interrupted to support a recommendation for extraterritorial application in non-enforcement cases.

B. Public Policy Considerations

The general deterrence of fraud and protection of purchasers of securities are public policy factors that favor extraterritorial application of U.S. securities law. One of the primary reasons given for extending jurisdictional reach to Foreign-Cubed cases under Section 10(b) is that the United States does not want to become a safe harbor for fraudulent activity. It can be argued that the United States has the best class action system and, thus, should litigate global class action suits. Proponents of this idea argue that fear of a large settlement figure may deter companies from engaging in fraudulent behavior.¹⁰⁹ However, foreign nations have their own securities regulations in place tailored to the needs and interests of their own

¹⁰⁷ 156 Cong. Rec. H5233 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski).

¹⁰⁸ *Id.*

¹⁰⁹ Peter M. Saporoff & Katherine Coughlin Beattie, *The Benefits of Including Foreign Investors in U.S. Securities Class Action Suits*, in SECURITIES LITIGATION: PLANNING AND STRATEGIES, at 669, 671 (ALI-ABA Course of Study 2008).

citizens.¹¹⁰ Thus, though extraterritorial application of U.S. securities law may contribute to preventing fraud, it is not necessary to achieving this public policy goal.

C. International Consequences

Opponents to extraterritoriality in cases involving foreign issuers whose shares are not traded on an American exchange often cite international backlash as a primary reason for their opposition. If the United States forces its laws on foreign companies, it may face international backlash, including having American companies hailed into court in a foreign jurisdiction or a decrease in foreign investment in the United States.¹¹¹ A number of factors, including the status of class action suits in foreign jurisdictions, the securities laws regulating the foreign exchange on which the foreign issuer's shares are traded, and the importance of state sovereignty in regulating one's own corporations and exchanges, counsel against the extraterritorial application of U.S. securities law.¹¹²

1. Class Action Claims in Foreign Jurisdictions

The SEC's study should consider the procedural differences between the United States and foreign jurisdictions. Such an analysis reveals that legislative, cultural, economic, and political factors all influence a jurisdiction's decision to permit or not permit class actions.

Unlike the United States, not all countries permit class action suits, and some of the countries that do allow such suits have created systems that differ from the United States class action system.¹¹³ For example, Switzerland does not permit class action suits, but provides alternative remedies for group litigation.¹¹⁴ Some of these remedies include devices that allow "similarly situated individuals [to] sue together," allow an "organization [to] sue for its members with similar rights," and "allow a court to consolidate claims arising out of the same controversy."¹¹⁵ In fact, Switzerland considered adopting the U.S.-style class action suit into its Federal Code of Civil Procedure,¹¹⁶ but decided against it, "noting that such

¹¹⁰ See *infra* Part IV.C.1.

¹¹¹ See *infra* text accompanying notes 155–163.

¹¹² See, e.g., Samuel P. Baumgartner, *Class Actions and Group Litigation in Switzerland*, 27 NW. J. INT'L L. & BUS. 301, 303 (2007); Ted Allen, *More Nations Open the Doors to Securities Lawsuits*, INSIGHT GOVERNANCE (March 7, 2006 9:27AM), <http://blog.issgovernance.com/gov/2006/03/more-nations-open-the-door-to-securities-lawsuitsubmitted-by-ted-allen-director-of-publications.html>.

¹¹³ Allen, *supra* note 112.

¹¹⁴ Baumgartner, *supra* note 112, at 304.

¹¹⁵ *Id.* This differs from the class action available in the United States in that, in Switzerland, all parties must actively participate in the action.

¹¹⁶ *Id.* at 310 (citing Motion 98.3401, Jutzet Erwin, Einführung der Sammelklage im

a device is foreign to Swiss traditions.”¹¹⁷ In a message to Parliament, the Swiss government stated that:

[It] is alien to European legal thought to allow somebody to exercise rights on the behalf of a large number of people if these do not participate as parties in the action. . . . Moreover, the *class action* is controversial even in its country of origin, the U.S., because it can result in significant procedural problems. . . . Finally, the *class action* can be openly or discretely abused. The sums sued for are usually enormous, so that the respondent can be forced to concede, if they do not want to face sudden huge indebtedness and insolvency (so-called *legal blackmail*).¹¹⁸

Switzerland is not the only country to decline to adopt a class action device similar to that in the United States, and many of the countries that also decline do so for many of the same reasons: economic, jurisdictional, doctrinal, and cultural.¹¹⁹ In the United Kingdom, for example, the government has specifically decided against “creat[ing] a general ‘opt-out’ class action regime for securities litigation against issuers.”¹²⁰ Instead, the United Kingdom has adopted more of an “opt-in” procedure, whereby the plaintiffs must choose to join an action. In addition, under the Group Litigation Order, only named plaintiffs may bring a group action.¹²¹

A number of countries, however, permit class action suits, including Australia and Canada.¹²² Australia has allowed securities class actions

Arbeits-, Miet- und Konsumentenrecht).

¹¹⁷ See *id.*

¹¹⁸ Botschaft zur Schweizerischen Zivilprozessordnung (ZPO) [Message, the Swiss Code of Civil Procedure], BBL 7221, 7290 (2006) (Switz.), available at <http://www.admin.ch/ch/d/ff/2006/7221.pdf>.

¹¹⁹ Baumgartner, *supra* note 112, at 310–11 (“As in many other jurisdictions that have contemplated the adoption of a class action device, proponents of such a device in Switzerland face considerable doctrinal, jurisprudential, cultural, and economic objections. Among them are a traditional focus on the individual nature of a claim; limitation of judicial power vis-à-vis the legislature, thus disallowing the large-scale judicial discretion necessary to manage complex litigation; strong emphasis on the litigants’ right to be heard, which would need to be slighted in complex cases; different respective roles of judges and attorneys; lack of American-style fee structures and entrepreneurial lawyering; and the many practical changes that would be necessary to introduce a class action device. Moreover, there is a clear preference for legislation rather than litigation to deal with new social problems, including mass torts.”).

¹²⁰ Brief of the United Kingdom of Great Britain & Northern Ireland as Amicus Curiae Supporting Respondents at 12, *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010) (08-1191), 2010 WL 723009 [hereinafter Brief of the United Kingdom].

¹²¹ See *Civil Procedure Rules: Part 19 – Parties and Group Litigation*, r. 19.10–19.15, http://www.justice.gov.uk/civil/procrules_fin/contents/parts/part19.htm (last updated Apr. 1, 2012).

¹²² Allen, *supra* note 113.

since 1992,¹²³ and as of 2008, nine out of ten of the Canadian provinces permit class actions. In 1978, Quebec was the first province in Canada to permit class actions similar to those in the United States, and in 1992, Ontario began permitting class actions with the passage of the 1992 Class Proceedings Act.¹²⁴ In December 2009, the Ontario Superior Court certified the first class action involving secondary market disclosures in *Silver v. Imax*.¹²⁵

In *Silver*, the shareholders claimed that IMAX misrepresented financial statements and brought a motion for a class action for secondary market misrepresentation.¹²⁶ The original plaintiffs were two IMAX shareholders who purchased shares in IMAX on the Toronto Stock Exchange before IMAX restated its financial disclosures. Additionally, the two plaintiffs proposed to represent a global class of IMAX shareholders who acquired their shares on a securities exchange and petitioned the court for certification as a class proceeding.¹²⁷ Justice K. van Rensburg of the Ontario Supreme Court certified the class action and seemed to accept the “fraud-on-the-market” theory, which Canadian courts had previously rejected, by certifying the class.¹²⁸

The SEC should consider these procedural differences between the United States and foreign jurisdictions, especially as they pertain to class actions, in deciding whether to allow extraterritorial application of U.S. securities law. A jurisdiction’s procedural rules reflect its economic, political, and cultural ideologies. Disregarding these differences could interfere with the regimes tailored to the interests and ideologies of foreign nations and result in international backlash, in addition to causing economic consequences.¹²⁹

2. Choice of Law

A corporation’s choice of which law to subject itself to is an important consideration in deciding whether U.S. securities law should apply extraterritorially. Corporations purposely avail themselves of a specific jurisdiction’s laws when they decide to list their securities on that country’s exchange. It is unfair to force the laws of country A upon a party in country B, especially when the party has purposely chosen not to conduct business in country A. In *Morrison*, National’s shares were traded on the Australian

¹²³ *Id.*

¹²⁴ Class Proceedings Act, S.O. 1992, c. 6 (Can.). The Federal Court of Canada also permits class actions.

¹²⁵ See LAMONT & ETZOLD, *supra* note 12, at 35.

¹²⁶ *Silver v. Imax Corp.* (2009), 66 B.L.R. 4th 222, at 5 (Can. Ont. Sup. Ct. J.).

¹²⁷ *Id.*

¹²⁸ *Id.* (“Liability follows proof of the misrepresentation, without the need to prove reliance, subject to certain statutory defences.”).

¹²⁹ See *infra* Part IV.D.

Stock Exchange and on other foreign securities exchanges but were not traded on any exchanges in the United States.¹³⁰ National only had two contacts in the United States: (1) the subsidiary HomeSide Lending headquartered in Florida, and (2) American Depositary Receipts listed on the NYSE.¹³¹ To the extent that a corporation chooses not to list its securities on a U.S. exchange, it is difficult to justify subjecting them to the laws of the United States. The differences among securities laws across multiple countries are so material that a corporation cannot reasonably be expected to act in accordance with regulations in jurisdictions in which it chooses not to list its securities.

Many countries regulate their own exchanges, “[a]nd the regulation of other countries often differs from [the United States] as to what constitutes fraud, what disclosures must be made, what damages are recoverable, . . . and many other matters.”¹³² In the United States, in order to establish a cause of action under Section 10(b)(5) of the Exchange Act, the plaintiff must show (1) that there is a misstatement or omission, (2) that the misstatement or omission is material, (3) scienter, (4) a nexus between the deceptive practice and the purchase or sale of a security, (5) the plaintiff relied on the misstatement or omission, and (6) economic loss.¹³³ In the United States, there is a presumption of reliance on the misstatement or omission. This presumption, which was articulated in *Basic v. Levinson*, is called the “fraud-on-the-market theory.”¹³⁴ This theory establishes a rebuttable presumption of reliance in securities fraud causes of action.¹³⁵

Other countries take markedly different approaches, however. In the United Kingdom, for example, the Financial Services Authority (FSA) is the non-governmental statutory authority responsible for the regulation of the financial services industry in the United Kingdom.¹³⁶ The FSA regulates most financial services markets, financial exchanges, and financial firms.¹³⁷ Its enforcement powers include the ability to:

[I]mpose penalties for a breach of its listing rules, disclosure rules, prospectus rules or transparency rules; impose penalties for market abuse; bring criminal proceedings for specified misleading statements and practices; fine or censure authorized firms; apply for an injunction where there is reasonable likelihood of contravention,

¹³⁰ *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010).

¹³¹ *Id.* at 2869.

¹³² *Id.* at 2885.

¹³³ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

¹³⁴ *Basic v. Levinson*, 485 U.S. 224, 225 (1988).

¹³⁵ *Id.*

¹³⁶ *What We Do*, FIN. SERVS. AUTH., <http://www.fsa.gov.uk/pages/About/What/index.shtml> (last updated Sept. 30, 2010). The FSA was created by the Financial Services and Markets Act of 2000.

¹³⁷ *Id.*

or continuing contravention, of the FSMA; and order restitution where any such provision has been contravened.¹³⁸

Further understanding of the Financial Services and Markets Act 2000 (FSMA) and the United Kingdom's common law illustrates the remedies available for securities fraud in the United Kingdom. At common law, liability may arise in instances of both misrepresentations and omissions where there is a duty to disclose.¹³⁹ The FSMA statutory provisions provide for causes of action in cases where an investor suffers a loss resulting from any misrepresentation or omission where disclosure is required.¹⁴⁰ Furthermore, similar to the United States' fraud-on-the-market theory, "section 90 does not specify a requirement of 'reliance.'"¹⁴¹

The requirements for fraud in the United Kingdom differ from those in the United States in two primary ways. First, unlike the United States, the FSMA does not require a showing of scienter.¹⁴² Second, the standard for materiality differs between the two countries. In the United States, a statement or omission is material if it "may affect the desire of investors to buy, sell, or hold the company's securities,"¹⁴³ and "would have been regarded by a 'reasonable investor as having significantly altered the 'total mix' of information available."¹⁴⁴ Conversely, in the United Kingdom, the standard for materiality depends on the type of corporate statement.¹⁴⁵

These differences in statutory construction among different nations "reflect legitimate policy decisions" of each nation.¹⁴⁶ Thus, the SEC should consider the regulatory landscapes of foreign jurisdictions when conducting its study of the application of extraterritoriality in securities litigation. It is unreasonable to hold a company that only lists its securities on a United Kingdom securities exchange and, in doing so, submits to the regulations and jurisdiction of the United Kingdom, to U.S. securities regulations as well. The opposite is also true. Corporations whose securities are registered and traded only on U.S. exchanges should not be expected to submit to the laws and regulations of foreign jurisdictions. The

¹³⁸ Brief of the United Kingdom, *supra* note 120, at 7–8 (citing FSMA Pt. VI, § 91; FSMA Pt. VIII; FSMA Pt. XXVII, § 397; FSMA Pt. XIV; FSMA Pt. XXV, §§ 380–81; FSMA Pt. XXV, §§ 382–84).

¹³⁹ *Id.* at 8.

¹⁴⁰ *Id.* (discussing § 90 of the FSMA).

¹⁴¹ *Id.* at 8–9.

¹⁴² *Id.*

¹⁴³ *Id.* at 16 (citing SEC v. Tex. Gulf Sulfur, 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

¹⁴⁴ *Id.* (citing TSC Indus. Inc v. Northway, Inc., 426 U.S. 438, 449 (1976)).

¹⁴⁵ PAUL DAVIES, DAVIES REVIEW OF ISSUER LIABILITY: LIABILITY FOR MISSTATEMENTS TO THE MARKET: A DISCUSSION PAPER BY PROFESSOR PAUL DAVIES QC (March 2007), <http://www.treasurers.org/system/files/daviesdiscussion260307.pdf>; see also Brief of the United Kingdom, *supra* note 120, at 18.

¹⁴⁶ Brief of the United Kingdom, *supra* note 120, at 11.

SEC should not want to invite other countries to pass similar extraterritorial laws or for the United States to be accused of hypocrisy if it refuses to submit to the jurisdiction of a foreign country.

3. *International Comity*

International comity is another concern that should weigh on the SEC's consideration of extraterritoriality. International comity is the principle of legal reciprocity,¹⁴⁷ meaning the mutual exchange and enforcement of privileges and judgments between nations. As a member of the international community, the United States should respect state sovereignty.¹⁴⁸ Extraterritorial application of U.S. law "disrespects foreign sovereignty because it infringes upon the authority of nations to regulate their own citizens and securities exchanges in the manner they see fit."¹⁴⁹

Critics have asked how the United States would respond in a similar situation—if a United States corporation were to be haled into a court in a jurisdiction in which it has not consented to that jurisdiction's laws. In such circumstances, the United States has typically objected to jurisdiction and "threatened adverse consequences."¹⁵⁰ For example, the international community has tried to extend its laws to the United States, including those of the International Criminal Court. The United States' "position has long been that even trial by an international tribunal, . . . would 'imping[e] on the sovereignty of the United States' to the extent that it would give others an ability to second-guess U.S. policy decisions."¹⁵¹ If the SEC finds that the extraterritorial jurisdiction should be applied to private rights of action under Rule 10b-5, it risks injuring its international standing.¹⁵²

Like the United States, foreign "[n]ations have a strong interest in regulating their own financial markets, developing disclosure rules to govern their own issuers, deciding how and when class action shareholder litigation should occur and determining the penalties for violations of such laws."¹⁵³ As illustrated above, these interests vary among nations. An SEC finding of extraterritoriality in private securities fraud claims would be a direct violation of international comity and customary international law. Well-established standards of international law clearly state that a nation

¹⁴⁷ ENCYCLOPEDIA BRITANNICA, <http://www.britannica.com/EBchecked/topic/930442/international-comity> (last visited August 12, 2012).

¹⁴⁸ Brief of Amicus Curiae the Organization for International Investment in Support of Respondents at 7–8, *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010) (No. 08–1191), 2010 WL 719335 [hereinafter Brief for Organization for International Investment].

¹⁴⁹ *Id.* at 3.

¹⁵⁰ *Id.* at 11.

¹⁵¹ *Id.* at 12 (citing JENNIFER ELSEA, CONG. RESEARCH SERV., RL31495, U.S. POLICY REGARDING THE INT'L CRIMINAL CT., 3–4 (2002)).

¹⁵² *Id.* at 12.

¹⁵³ Brief of the United Kingdom, *supra* note 120, at 22.

shall not exert jurisdiction over persons or activities of another nation if such a finding of jurisdiction would be unreasonable.¹⁵⁴ A finding of jurisdiction in F-Cubed or F-Squared cases is unreasonable because it could potentially subject corporations to laws that are inconsistent with those of the country whose laws they have chosen.

D. Economic Consequences

The unpredictable and inconsistent application of extraterritorial jurisdiction in U.S. courts may lead to a number of negative economic consequences. For example, the lack of a bright-line rule may deter foreign investment in the United States. As the Court recognized in *Hertz Corp. v. Friend*, “predictability is valuable to corporations making business and investment decisions.”¹⁵⁵ A corporation is unlikely to conduct business in a country where the effect of the laws on the corporation is unpredictable and its application inconsistent. In fact, in the time period leading up to *Morrison*, more than sixty foreign companies left U.S. capital markets.¹⁵⁶

¹⁵⁴ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 403 (1987). Whether jurisdiction is unreasonable is determined by evaluating the following factors:

- (a) the link of the activity to the territory of the regulating state, i.e., the extent to which the activity takes place within the territory, or has substantial, direct, and foreseeable effect upon or in the territory;
- (b) the connections, such as nationality, residence, or economic activity, between the regulating state and the person principally responsible for the activity to be regulated, or between that state and those whom the regulation is designed to protect;
- (c) the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted.
- (d) the existence of justified expectations that might be protected or hurt by the regulation;
- (e) the importance of the regulation to the international political, legal, or economic system;
- (f) the extent to which the regulation is consistent with the traditions of the international system;
- (g) the extent to which another state may have an interest in regulating the activity; and
- (h) the likelihood of conflict with regulation by another state.

Id.

¹⁵⁵ *Hertz Corp. v. Friend*, 130 S. Ct. 1181, 1193 (2010); *see also* *First Nat. City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983) (recognizing the “need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation”).

¹⁵⁶ SULLIVAN & CROMWELL LLP, THE TERRITORIAL REACH OF U.S. SECURITIES LAWS AFTER *MORRISON V. NATIONAL AUSTRALIA BANK* 3–4 (Sept. 29, 2011), http://www.sullcrom.com/files/Publication/e82481b6-957a-44c2-a894-335409d295ef/Presentation/PublicationAttachment/befe45a9-05e5-485f-92e4-365755c5c1a4/SC_Publication_The_Territorial_Reach_

During the two-year period between June 2007 and June 2009, “15 out of 27 French companies listed in the United States at the end of 2005 had de-listed, as had 19 of 44 United Kingdom companies, seven of 20 German companies, six of 11 Italian companies, and 15 of 24 Australian companies.”¹⁵⁷

A number of reasons have been given for this flight. First, the SEC, in June 2007, “amended its rules to remove certain barriers to de-listing.”¹⁵⁸ This made it easier for foreign companies who feared U.S. litigation to leave U.S. capital markets, and thus, decrease their risk of being the target of securities litigation in the United States. Second, the monetary awards in private anti-fraud litigation increased.¹⁵⁹ In 2009, the average settlement was \$38 million, a 65% increase over the \$23.1 million figure in 2008.¹⁶⁰ This increased the potential economic consequences for a foreign company choosing to list its securities on a U.S. exchange.

Third, foreign companies fear the possibility of duplicate recovery.¹⁶¹ This possibility, however, is not a significant fear because “these concerns may be dealt with through interlocutory motions about group definition so that a participant in one class action is excluded from another,”¹⁶² or through a waiver and release from future claims. In *In re Royal Ahold N.V. Securities and ERISA Litigation*, the plaintiffs were required to “release any claims against the specified defendants and a variety of related persons, covenant not to sue the specific defendants, and waive all claims related to the subject matter of the settlement.”¹⁶³ Such a release in similar cases would render the issue of duplicate recovery moot.

After analyzing the factors above—legislative history, public policy justifications, international consequences, and economic consequences—the SEC should not modify Rule 10b-5 of the Exchange Act to include

of *US Securities Laws.pdf*; see also John C. Coffee, Jr., *Securities Policeman to the World? The Cost of Global Class Actions*, N.Y. L.J., Sept. 18, 2008, at 5 (“[W]hile the press and others attribute the growing disenchantment of foreign issuers with the U.S. market to Sarbanes-Oxley Act, closer analysis and interview data suggests that fear of U.S. private antifraud litigation may be the better explanation [for the flight of foreign companies from U.S. capital markets].”).

¹⁵⁷ SULLIVAN & CROMWELL LLP, *supra* note 156, at 4.

¹⁵⁸ *Id.*

¹⁵⁹ LAMONT & ETZOLD, *supra* note 12, at 39.

¹⁶⁰ *Id.*

¹⁶¹ ROSS BUCKLEY, *The Extraterritorial Application of US Securities Class Actions*, 83 AUSTRALIAN L.J. 373, 375 (2009) (“If class actions are provided for in the foreign jurisdiction, there is a possibility of overlap as claims can be brought in the US court and a court in another country giving rise to double recovery or forum shopping.”); see also Tanya J. Monestier, *Is Canada the New Shangri-La of Global Securities Class Actions?*, 32 Nw. J. INT’L L. & BUS. 305 (2012).

¹⁶² *Id.*

¹⁶³ Saporoff & Beattie, *supra* note 109, at 675; see generally *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334 (D. Md. 2004).

extraterritorial jurisdiction.

V. RECOMMENDATION FOR A NEW BRIGHT-LINE TEST

The SEC should establish a clearly defined bright-line rule regarding the extraterritorial application of Section 10 of the Exchange Act and Rule 10b-5 in private causes of action. The SEC should formally reject the unpredictable conduct and effects tests created by the Second Circuit and adopted in various forms by the other circuits,¹⁶⁴ and instead adopt language that is consistent with the transaction-based test in *Morrison*. Additionally, the SEC should further clarify the definition of what constitutes the purchase of a security; more specifically, the SEC should define the level of activity in the United States necessary for a security to be considered purchased in the United States. Lastly, while not directly related to civil F-Cubed litigation, the SEC and Congress should reconsider the extraterritoriality of enforcement actions brought by the SEC and the Department of Justice.

In *Morrison*, the Court held that Section 10(b) “reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”¹⁶⁵ The SEC should recommend the adoption of similar language, construing Section 10(b) and Rule 10b-5 to only apply to those securities that are bought or sold on an American exchange. If the security is not listed or traded on an American exchange, the SEC should look to the issuer’s principal place of business as well as where the investor and the issuer consummated the transaction.

To determine the location of the consummation of the transaction, the courts should consider a number of relevant factors. These factors include whether the purchaser is a resident of the United States, whether a broker or underwriter located in the United States was used in the transaction, and whether U.S. mails or wire services were used in the purchase or sale of the security. None of these factors is dispositive, but the courts should conduct a balancing of the factors. For example, if all three of the factors are answered in the affirmative, a court may find that the purchase or sale of the security took place in the United States.

The SEC has the authority to regulate American exchanges, but should not regulate foreign corporations who choose to list only on foreign exchanges. The SEC has an interest in protecting American markets—and thereby American citizens—from fraud both at home and abroad. Adoption of the transactional test is the best means to achieve this interest. Under such test, a foreign corporation that chooses to list its securities on a U.S.

¹⁶⁴ See *supra* Part II.

¹⁶⁵ *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2888 (2010).

exchange will be subject to the laws of the Exchange Act.

Additionally, the SEC's adoption of the transaction-based test respects state sovereignty and follows principals of international comity by regulating only those transactions where either the security is traded on an American exchange or the purchase or sale of the security takes place in the United States. The test also creates a predictable and consistent rule for courts to apply. In addition, it preserves the United States' interests in protecting American exchanges from fraudulent activity. This is true because, under the test, all securities traded on American exchanges or purchased or sold in the United States, whether issued by U.S. corporations or foreign corporations, fall under U.S. securities laws.

The bright line test must also include a clear definition of when the purchase of a security takes place in the United States. The district court in *Plumbers' Union* considered this issue in depth.¹⁶⁶ The plaintiffs argued that a purchase occurs "when and where an investor places a buy order."¹⁶⁷ The court stated that "as a general matter, a purchase order in the United States for a security that is sold on a foreign exchange is insufficient to subject the purchase" to the anti-fraud provisions of the Exchange Act.¹⁶⁸ The court looked to a number of matters in reaching this conclusion. First, the plaintiffs did not claim that the purchase made in Chicago was irrevocable, nor did they dispute the fact that the security purchase was made on a foreign exchange.¹⁶⁹ Second, the court emphasized that, if the plaintiffs' reasoning were accepted, it would require a fact-based, case-by-case inquiry into when and where the investor's purchase order became irrevocable.¹⁷⁰ An inquiry such as this would inevitably lead to inconsistent rulings—exactly the kind the Court in *Morrison* was trying to avoid. To avoid this problem, the SEC should provide clear and concise guidance as to when and where a security purchase occurs.

Lastly, for these same reasons, the SEC should consider codifying the transactional test in enforcement actions brought by the SEC and the Department of Justice. Under the Dodd-Frank Act, Section 929P provides for extraterritorial jurisdiction in cases where there is either significant conduct in the United States or where the foreign conduct has a substantial effect in the United States.¹⁷¹ Congress and the SEC should reconsider whether subjecting foreign issuers, whose securities are not listed on an

¹⁶⁶ See *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166 (S.D.N.Y. 2010).

¹⁶⁷ *Id.* at 177 (where the purchase order in question was placed in Chicago and the security purchased was traded on the Swiss stock exchange).

¹⁶⁸ *Id.* at 178.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864 (2010).

American exchange, to U.S. securities laws and regulation is in line with customary international law. Based on a balancing of the reasons discussed above for finding that there should be no private cause of action in Foreign-Cubed cases, the same analysis supports the conclusion that the SEC should not apply the anti-fraud provisions of the Exchange Act extraterritorially to SEC and Department of Justice enforcement actions.

VI. CONCLUSION

United States jurisdiction over Foreign-Cubed cases has been the subject of much discourse among the international community. Traditionally, American courts have asserted jurisdiction for one of two reasons: (1) because the fraudulent conduct occurred in the United States; or (2) because the fraudulent conduct had a substantial effect on the United States. While the two tests seem clear in theory, the district courts' applications of the conduct and effects tests have been unpredictable and inconsistent.

Additionally, the international community strongly opposes the application of U.S. securities law on foreign corporations, especially those who intentionally choose not to list their securities on American exchanges. Foreign jurisdictions oppose the application of extraterritoriality in U.S. securities litigation for a number of reasons, including the existence of their own securities laws in their home countries, and international comity.

In June 2010, the United States Supreme Court in *Morrison* rejected the conduct and effects tests and adopted a transactional test, which looks to whether the fraud was committed in connection with the purchase or sale of a security on an American exchange. However, the Dodd-Frank Act, which was passed in July 2010, put the ball back into the SEC's court. The Dodd-Frank Act commissioned the SEC to conduct a study and make a recommendation regarding the extraterritoriality of Section 10(b) of the Exchange Act and Rule 10b-5.¹⁷² This article argues that the SEC should consider a number of factors, including the legislative and judicial history of the extraterritoriality of Section 10(b) and Rule 10b-5, the policy reasons for and against extraterritoriality, and the international and economic consequences of extraterritoriality. Finally, this article recommends that the SEC adopt a bright-line test that mirrors the test adopted by the Supreme Court in *Morrison*. Additionally, this article recommends that Congress and the SEC reconsider the extraterritorial application in SEC and Department of Justice enforcement actions when foreign issuers who do not trade their shares on American exchanges are involved.

¹⁷² *Id.* § 929Y, 124 Stat. at 1871.

